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Financial Market Review Second Quarter, 1999

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Following the end of the first quarter of 1999, the financial press was filled with articles with such titles as "The Death of Diversification" and "Is Asset Allocation a Myth?" It had been a quarter when large company US growth stocks continued to leave every other traditional asset class in their wake in terms of performance, and investors were legitimately questioning why they should be invested in anything other than that class of stocks. After all, investors were enduring significant opportunity costs by being in other asset classes in recent years.

Proponents of diversification and asset allocation breathed a huge sigh of relief during the second quarter as small and mid-sized stocks outpaced the large capitalization stocks, value stocks outperformed growth stocks, and basic industrial and cyclical stocks came to the fore as technology and Internet stocks either took a breather or, in some cases, suffered sharp declines from earlier highs.

After changing direction a number of times during the quarter, the US stock market ended June with a particularly exuberant tone, as investors reacted positively to the Federal Reserve's decision on June 30 to raise the federal funds rate only a quarter of a point and to drop its earlier stated bias toward raising rates further. The Standard & Poor's 500 Index and the NASDAQ Composite both raced to new highs and the Dow Jones Industrial Average would surpass its record (set in May) over the next two trading days.

The most interesting trends for the second quarter could be seen by looking at and through the major market indices. (See accompanying table.) Indeed, they portray a real reversal of fortune. Whereas the S&P 500 Index of growth-oriented large capitalization stocks had been significantly outpacing all other market sectors for several years, that Index (up 7.05% for the quarter) was trounced by the basic industrial stocks in the DJIA (12.11%) and more than doubled by the standard mid-cap (14.16%) and small-cap (15.55%) indices.

The reversal in market leadership was due to a significant change in investors' perception of the [CONTINUED ON PAGE 2]

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[FROM PAGE 1] economic landscape. At the beginning of the year, investors expected sluggish economic growth at best and were willing to pay big premiums for those companies—such as prominent technology firms—that were thought to be able to deliver strong earnings, even in a weak economy. As the second quarter progressed, it was apparent that growth was more rapid than anticipated and investors concluded that they could find strong earnings in a wide swath of industries, not a select few. Thus, they began to take much greater interest in those companies that were selling at far smaller price multiples relative to expected earnings than the previous high fliers. Also, with interest rates trending higher, investors pulled back from richly-valued growth companies because higher rates make it more expensive to wait for the big future earnings gains that those companies promise.

During the second quarter, the best performing industry groups included such previously unglamorous sectors as aluminum (up 45.4%), industrial technology (38.2%), transportation equipment (31.1%), and heavy construction (26.6%). By contrast, it was a time for consolidation and profit-taking among previous winners: Amazon.com lost 27.3% for the quarter and was down 45% from its April high, while America Online was down 25.2% for the quarter and down almost 40% from its recent high. Although still up handsomely for the year, most Internet stocks experienced a healthy correction during the second quarter as investors gravitated to those companies that could offer real earnings as opposed to mere yearnings.

Overseas, European stock markets were generally sluggish as economic growth rates were disappointing. With last year's economic scare well behind them, Asian markets enjoyed a powerful recovery.

Analysts were unsure whether the country's long dormant economy had finally bottomed, but Japan's market also showed surprising strength.

While many investment professionals and investors cheered the stock market's changed leadership during the second quarter, one major asset class still faced a gloomy present and an uncertain future. With the exception of high yield corporate ("junk") bonds, all segments of the fixed income market suffered negative returns during the quarter as interest rates generally rose in response to the economy's stronger than expected growth and fears that the Federal Reserve might embark on a series of policy tightenings in order to dampen inflationary expectations. The market stabilized after the Fed's well-received actions of June 30, but the benchmark 30-year Treasury bond still rose in yield from 5.62% to 5.96% for the quarter, having begun 1999 at 5.10%. The rate on these bonds had been as low as 4.70% at the height of the flight to quality that accompanied last summer's economic and financial market scare. All segments of the fixed income market have negative total returns for the year-to-date with the exception of modest positive returns recorded by mortgage securities and high yield bonds.

In other markets, the improved economic outlook has proven to be a tonic for Real Estate Investment Trusts, which have recently recovered from last year's debacle to register positive returns for the year. Private real estate investments continue to reflect the strong economy by registering healthy returns. When second quarter results become available over the coming months, returns on venture capital and other forms of private equity should generally follow the continued upward trend in public equity values.

Looking forward, much attention will be focused on the [CONTINUED ON PAGE 5]

SECOND QUARTER 1999

U.S. EQUITY MARKET

INDEX	DESCRIPTION	SECOND QUARTER RETURN	YEAR-TO-DATE, 1999
DOW JONES INDUSTRIAL AVG.	30 INDUSTRIAL STOCKS	12.53%	20.46%
STANDARD & POOR'S 500	LARGE CAP STOCKS	7.05%	12.38%
NASDAQ COMPOSITE	TECHNOLOGY-DOMINATED	9.13%	22.50%
WILSHIRE 5000	BROAD MARKET INDEX	7.80%	11.87%
S&P MIDCAP 400		14.16%	6.87%
RUSSELL 2000	SMALL CAP STOCKS	15.55%	9.28%

GROWTH vs VALUE

	FIRST QUARTER	SECOND QUARTER
S&P 500 GROWTH	6.88%	3.83%
S&P 500 VALUE	2.85%	10.80%

GLOBAL MARKETS

	SECOND QUARTER	YEAR-TO-DATE
M.S.C.I. - E.A.F.E.	2.19%	3.24%
M.S.C.I. - EMERGING MARKETS	25.38%	40.93%

REAL ESTATE

	FIRST QUARTER	SECOND QUARTER
NAREIT - EQUITY REAL ESTATE INVESTMENT TRUSTS	- 4.82%	10.08%
NCREIF PROPERTY INDEX	2.53%	N.A.

FIXED INCOME MARKET

	SECOND QUARTER	YEAR-TO-DATE
LEHMAN BROTHERS AGGREGATE INDEX	- 0.88%	- 1.37%
LEHMAN BROTHERS CORPORATE INDEX	- 1.56%	- 2.26%
LEHMAN BROTHERS GOVERNMENT INDEX	- 0.85%	- 2.27%
LEHMAN BROTHERS MORTGAGE INDEX	- 0.45%	+ 0.45%
FIRST BOSTON HIGH-YIELD INDEX	+ 1.16%	+ 2.82%

GLOSSARY

Dow Jones Industrial Average: A price-weighted index tracking thirty large industrial companies selected by the editors of *The Wall Street Journal*.

Standard & Poor's 500 Index: A broad-based market index, weighted by market capitalization, that comprises about 75% of the total market value of publicly traded US equities.

NASDAQ: The National Association of Securities Dealers Automated Quotation System is an over-the-counter trading exchange used mainly by newer, technology-oriented companies.

Russell 2000: The major index that tracks small capitalization stocks.

Large Capitalization Stock: Total market value of outstanding stock exceeds \$5 billion.

Mid-cap stock: Between \$1.5-5 billion in market capitalization.

Small-cap stock: Less than \$1.5 billion market value of stock outstanding.

Growth stock: Stock of companies that, due to their strong earnings potential, offer above-average prospects for capital appreciation, with less emphasis on dividend income.

Value stock: Stocks that, considering a company's assets and earnings history, are attractively priced relative to current market standards of price-to-earnings ratios, price-to-book ratios, et al. They typically pay regular dividends to shareholders.

Price/Earnings Ratio: Sometimes referred to as

the "multiple", the P/E Ratio is the stock price divided by the company's net income per share over the past twelve months.

Treasury yield: The current market interest rate on bonds issued by the US Treasury with a specific maturity date (i.e. 30 years). Bonds are issued at a specific interest rate and at a specific price (such as 100 or "par") but the subsequent price and yield will be determined every day by prevailing market conditions. If rates generally rise (fall) after initial issuance, the price of the original bond will fall (rise) in order to make the effective yield on the bond rise (fall) to a level consistent with those on currently issued securities.

Corporate bond spread: The "spread" is the incremental yield offered by corporate bond issuers over those of US Treasury securities of similar maturity. The spread is a measure of investors' willingness to assume the extra credit risk inherent in corporate securities compared to virtually riskless US Treasuries.

Federal Funds Rate: The rate at which reserve funds (\$1 million or more) are traded among commercial banks on an overnight basis

High-yield ("junk") bonds: Bonds rated below investment grade issued by corporations whose overall business or financial condition is relatively weak or risky. These bonds react less to general interest rate trends than do investment grade securities.

[FROM PAGE 3] fixed income market as the Fed continues to assess whether further interest rate increases will be necessary to keep the economy on a moderate, non-inflationary track. Nevertheless, it is the US stock market that continues to be the most closely watched market in the world. Its dramatic advance over the past several years has been a significant contributor to economic growth through the "wealth effect" and, with more households than ever involved in the market, it is feared that a sustained bear market could have dire consequences for both the domestic and the world economy. Many analysts maintain that the stock market could be at risk as a result of historically high price to earnings

valuations, moderate expected gains for future corporate profits, and the recent rise in interest rates. Others maintain that these models and analyses have lost their relevance because we are in a unique sustained period of low inflation brought on by increased productivity and technological change. In any event, the market at mid-year has already confounded many "experts" as an unprecedented fifth straight year of 20% or greater returns may well be within reach. Logic as well as historical perspective tell us that the extraordinary gains of recent years cannot be sustained, but with consumer confidence at a 30-year high, the event that is going to derail the bull market is not yet on the horizon. ♦



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